II. Contracts Promote Economic Efficiency and are Procompetitive

A. Benefits of contracts

3. At the most fundamental level, the only reason two parties enter into a contractual arrangement is because there are perceived mutual benefits that will flow from the implementation of its terms and conditions. Clearly, ILECs' customers can and do purchase access services from the generally available access tariffs and, therefore, are not obligated to enter into contracts in order to procure those services. Thus, it must be concluded that contracts for these services would only arise if it was determined by the contracting parties that there were mutual benefits from entering into them.

4. ILECs' contracts for access services could contain a variety of arrangements tailored to the needs of specific customers. For example, among other terms that might be agreed upon, contracts for access charges generally could be expected to include provisions for length of term commitments, volume discounts and minimum charges for the services rendered as well as other types of special pricing and provisioning and service arrangements.

5. Contracts with large customers can and do contain a wide of variety of services and are usually not just a simple discount for larger volumes of purchase. They often include such things as network management services, alternate or enhanced billing arrangements, specialized offerings or network configurations and a host of other possibilities. For example, MetLife uses AT&T services "to support its diverse voice and data business applications at more than 1,500 locations nationwide" and its internal network management center has direct access to AT&T service platforms for repair and notification.[1] Contracts such as this are themselves competitive offerings and a collection of tailored services from the LEC, competitive local exchange carrier (CLEC) or interexchange carrier (IXC). It is inappropriate to think of them as a simple array of services that could otherwise be purchased from a tariff. Indeed, the sum of what is contained within a contract is often substantially greater than its parts.

6. As a general matter, the contractual terms will result in a sharing of the benefits and cost savings that result from two parties negotiating the terms and conditions of their supplier-customer relationship. Further exploration of the benefits accruing to both parties in contracts containing term and volume (or minimum charge) commitments

[1] "MetLife Renews and Expands Network Agreements with

clearly demonstrates the nature of the benefits that would be derived by both the parties and society as a whole, and makes clear that denial of the opportunity to enter such contracts reduces overall consumer welfare and is not in the public interest.

7. The ability to enter contracts for term and volume discounts with customers provides a supplier with the necessary flexibility to align its prices and costs with lower transaction and production planning costs. Term and volume discounts are standard practice in the pricing of telecommunications services and are pervasive throughout competitive industries. Their presence in these types of markets provides strong market evidence of the importance of these pricing practices in the competitive process.

8. In fact, volume/term pricing plans are widely used throughout our economy because the costs of providing goods or services always vary with the volume and/or term of the purchase. In addition to telecommunications, I have previously studied both wholesale and retail pricing practices and policies in dozens of industries, including:

AT&T," AT&T Press Release, August 25, 1993.

- transportation services (airlines, motor carriers, package delivery services, taxi service, railroads, Great Lakes barge and port services);

- distribution services (wholesale/retail sales of groceries, cellular phones, auto tires, hair care products, consumer electronics, video games and game players, musical instruments, and recreational vehicles parts and accessories);

- financial, insurance and real estate services (worker's compensation insurance, credit card services to member banks and merchants, retail rental space in regional shopping centers, agricultural crop loans);

- health care services (vision care benefits plans, optical and ophthalmic goods and services);

- manufactured products (semiconductors, semiconductor manufacturing equipment, biotechnology manufacturing equipment, corrugated steel products, electronic lighting products, chemical lighting products);

- entertainment and publishing (movie production, distribution and exhibition, magazine publishing, cable

TV distribution of live events, live events ticketing services);

- construction services (specialty steel fabrication, furnace pipe and fittings, electrical contracting, disaster recovery and cleanup services).

9. In every one of these industries, without exception, I have observed that either volume and/or term discount pricing plans were a significant and customary feature of both wholesale and retail pricing. Clearly, there are volume and term-related discounts at the retail level. However, volume-based discounts are small at the retail level when compared to those observed at the wholesale level. In every industry I have studied the same rule applies: those who buy more pay less per unit.

10. Importantly, two fundamental reasons underlie the fact that term and volume discounts are standard practice in so many industries. First, they provide the flexibility to align prices and costs and second, they decrease the costs and uncertainty on both sides of the transaction.

11. We already know that term and volume commitments are commonplace in the long distance segment of the telecommunications market. In a later section, I elaborate on the regulatory and marketplace experience with that

phenomenon. At this point, it is sufficient to point out that the combination of term and volume discounts for longer haul usage services is due in part to the strong incentive for facilities based service providers to fill existing capacity and assure a stable revenue stream to improve capacity utilization. In specific competitive circumstances, it is imperative that long distance providers have the ability to provide these situational offers. These same incentives provide the impetus for offering term and volume discounts for wholesale access services.

B. Contracts help bring prices to efficient levels

12. The central tenet of market economies is that prices play a critical role in the allocation and distribution of goods and services. When cost savings arise through commitments of larger volume purchases or other contractual terms, discounts provide the proper price signals for the efficient allocation and distribution of services and, therefore, the development of efficient competition. Regulations that impede the use of discounts or similar mechanisms for sharing cost savings under contracts impede competition and prevent customers from obtaining the lowest possible price for the services they purchase.

13. Term and volume discounts or other similar terms actually can serve to reduce costs by the avoidance of costs

involved in short term agreements and the resulting increased customer and usage instability. For wholesale customers, discounts decrease uncertainty about the price of an important input and the cost of developing working relationships with suppliers. For service providers there is less uncertainty in the network planning and investment process and more certainty of a steady revenue stream. In a competitive market, discount plans are negotiated that share the benefits of these cost savings between buyers and sellers.

14. From an economic efficiency perspective, then, allowing contracts that include terms reflecting cost savings and reduced uncertainty leads to prices that are lower than they otherwise would be and leads to prices that are more in accord with the actual costs for which a service can be provided. These economic efficiency benefits arise regardless of the extent to which each and every contract is a result of competitive bidding, although competition underscores the need and the incentive for individual customer contracts.

C. Contracts are Procompetitive

15. As I have described above, allowing contracts to be entered into that share cost savings and include prices more closely reflecting actual costs leads to greater economic

efficiency and, therefore, is a desirable policy. The most obvious point is that, if an ILEC is unable to make a competing offer to a customer when CLECs can, customers will move to CLECs regardless of whether those firms are more efficient and have lower costs.

16. In the face of competition, there are positive reinforcing implications for competition from allowing contracting while there are definite negative results from their being disallowed. These positive effects would flow from opening up the opportunity for ILECs to compete effectively for all customers' business. As it stands now, not allowing ILECs to compete with contractual offers essentially removes one of the most effective competitors from the competitive process. This has two synergistic negative effects. First, an ILEC, such as U S WEST, is unable to make a competing offer and thus is not permitted to offer a lower price or better package of services than those who are in the bidding. The other negative effect is that the other bidders know that the ILEC is not in the competitive battle. This reduces the pressure on them to make price and service offers at as competitive a level as they otherwise would.

17. Contract pricing, then, would bring ILECs into the middle of the competitive fight, and lead to greater overall economic efficiency. As discussed above, contracts bring

prices closer to the level of costs and thus contribute to allocative efficiency, that type of economic efficiency concerned with the proper allocation of resources in our society. Just as importantly, though, increased competition leads to greater technical and dynamic efficiency as well. Technical efficiency refers to the use of the least amount of inputs to produce a given amount of output. Competition forces firms to operate as efficiently as possible in order to keep their costs down. Dynamic efficiency, as the name implies, relates to greater efficiency over time. Enhanced competition through allowing ILECs to offer services under contracts would lead to faster innovation, better quality service and other dynamic effects that are highly desirable in the burgeoning telecommunications marketplace.

18. In contrast, the current prohibition against contract pricing of interstate services by ILECs impedes competition and results in unrealized competitive benefits for the marketplace. If the potentially more efficient firm is not allowed to compete effectively with less efficient ones, then society suffers from having higher prices and higher costs than it otherwise would. In addition, if the handicapped but more efficient firm survives and later is allowed to offer such contracts, it will then successfully compete for the previously lost customer. This unnecessary customer churn, caused by inefficient restrictions on one competitor, will result in the imposition of unnecessary

transaction costs and misallocation of resources. For example, facilities may have been constructed by the less efficient firm that become stranded when it subsequently loses the customer. Or, the more efficient firm may have to replace or restore its facilities to serve the customer after regaining it. All of these costs and dislocations are unnecessary, inefficient and were caused purely by regulatory restrictions.

D. Asymmetric Regulation Harms Society

19. Asymmetric regulation, treating one competitor differently from another in the rules by which it can compete, can lead to a host of deleterious effects both on the firms affected and on society as a whole. Asymmetric regulation can reduce competition and result in an inefficient waste of society's scarce resources. Clearly, asymmetric regulation is appropriate in some cases. However, there is no need for asymmetry in the treatment of ILECs for access service contracts. Where asymmetric regulation has no sound basis, the ensuing societal losses are especially egregious since they were needless. As I discuss below, I believe there is no need for asymmetric treatment of dominant and non-dominant LECs[2] in the

[2] Most recently the Commission granted two petitions seeking exemption from filing requirements for CAPs and non-dominant providers of interstate exchange access

contractual provision and sale of access service and, therefore, am very concerned with the economic losses associated with the current rules regarding contracts.

20. The history of asymmetric regulation in the U.S. vividly demonstrates the harm that can result from the uneven treatment of competitive firms in a particular industry. I previously have surveyed the experiences in this country with the surface freight and financial services markets and described the disastrous results that came from overly restricting the activities of some firms in those markets while not constraining their competitors. Like ILECs, railroads and banks historically were the dominant firms in many of their respective markets. However, in both cases, surface freight transportation and depository financial services became increasingly competitive as entry, technological innovation, shifting consumer demands, and intermodal competition brought new firms into the market. In both cases, regulators failed to respond to growing competition and continued to regulate asymmetrically the

---

services. In that proceeding, the Commission also proposed adopting complete detariffing for all non-ILEC providers of these services, and adopted permissive detariffing in the meantime. Memorandum Opinion and Order and Notice of Proposed Rulemaking, *In the Matters of Hyperion Telecommunications, Inc Petition Requesting Forbearance, Time Warner Communications Petition for Forbearance, Complete Detariffing for Competitive Access Providers and Competitive Local Exchange*

incumbent banks and railroads, causing huge inefficiencies, declining financial performance and, ultimately, the expenditure of public funds to bail out failed firms. The parallels sound all too familiar between these markets and those in which the ILECs are participating. I urge the Commission not to repeat the costly mistakes made in those markets.

21. In both the surface freight transportation and the depository financial services markets, asymmetric policies were continued long after they had become counter-productive because competitors benefited from their continuation. In addition to the losses to society resulting from inefficient prices and production, the participating firms, themselves, unnecessarily can suffer devastating losses. LEC earnings and profitability will be substantially reduced if high volume customers continue to choose alternatives to ILEC services only because regulatory requirements prevent the ILEC from pricing to meet competition. The Commission must allow the ILECs to price their access services in efficient and competitive ways in order to send the right price signals to the market. Otherwise, the Commission will promote economically inefficient entry. If LECs are handicapped in competing for the most profitable market

---

Carriers, FCC CC Docket No. 97-146, Released: June 19, 1997.

segments, the segments most often the subject of contracts, they will be less able to provide low-cost, high quality service to the other market segments and will have reduced financial incentives to invest in the telecommunications infrastructure - especially in rural, high cost areas.

22. One other aspect of asymmetric regulation that is of special note is the fact that ILECs presently can offer intrastate services under contract for many or most of its services. In terms of U S WEST territories, every one of their states allows the offering of some form of contract tariffs. These authorizations range from special construction arrangements to individual case basis proposals. There is a general recognition by the state commissions that such arrangements are a necessity.

23. Why the Commission might not allow such arrangements whiles states do, seems inconsistent as well as asymmetric. Such asymmetry has become especially problematic in light of the fact that the competitors of the ILECs are precisely the same ones at both the intrastate and interstate levels. In fact, competitors' contracts join intra- and interstate services in arriving at a total package. ILECs are barred from competing then, or severely limited, because of their asymmetric treatment. The ILECs are treated differently from their competitors and they are treated differently between the intra- and interstate jurisdictions. In a

marketplace characterized by significant and increasing competition, this can not be allowed to continue.

24. Because asymmetric regulation benefits competitors but not competition, it is in the strategic interests of competitors to perpetuate it. This type of artificial competitive advantage is frequently sought by LEC competitors to interfere with the offering of new services or pricing options. An excellent example that Professor Richard Gilbert and I have previously cited[3] is one where, in December 1993, Bell Atlantic filed a petition to waive Part 69 rules to establish rate elements for InterLata Operator Services (IOS) to be furnished to small interexchange carriers who lacked the capability to self-supply IOS. Several large IXCs filed protests which were later dismissed by the Commission. However, it was a year later before the waiver was granted. In the mean time, Bell Atlantic's competitors used the lead time to develop services and sign long term contracts in anticipation of Bell Atlantic's entry into the market. By the time the tariff was approved, Bell Atlantic had lost the opportunity

---

[3] Affidavit of Richard J. Gilbert and Robert G. Harris on Behalf of Bell Atlantic, *In the Matter of Price Cap Performance Review for Local Exchange Carriers, Treatment of Operator Services Under Price Cap Regulation, Revisions to Price Cap Rules for AT&T*, FCC CC Docket Nos. 94-1, 93-124, 93-197, January 5, 1996.

to sign contracts with many potential customers. This type of gaming of the regulatory process clearly shows how competitors delay or stop LECs from being able to successfully compete in the marketplace. Again, the benefit is only to competitors. Everyone else is a loser, most notably the customers of interstate access services.

E. Competition Drives the Need for Contracts

25. The marketplace for access services continues to become more and more competitive as Competitive Access Providers (CAPs) continue their ambitious construction plans, backed by daunting success in raising capital. Since they have also become CLECs (as well as long distance, cellular, paging, and Internet players), they have mounted aggressive strategies for expanding their networks and increasing their market penetration. These competitors have already put considerable price pressure on special and switched access services and are in a position to discipline LECs that keep their access prices for business customers above competitive levels.

26. The key for CAPs/CLECs in competing for access services is their ability to selectively target business customers, bundle services in innovative and customer-specific ways, and utilize of the latest technology. Although there are some instances where CLECs, such as incumbent cable

operators, have obligations, it is most often incumbent LECs that face limitations. The first two are off limits to incumbent LECs, and the third (the last) is cumbersome with LECs' vast legacy systems and their universal service obligations. These CAP/CLEC advantages are being played out in major urban business centers and now in many second and third tier cities as well.

27. The ability of CAPs/CLECs to pick and choose business customers is particularly important in access services, because demand and hence revenue is highly concentrated. According to a recent Salomon Brothers report, of the 21,000 end offices "roughly 700-800 generate 70% of the business local revenue."[4] With target customers so tightly clustered, CAPs are able to efficiently and effectively deploy the high capacity fiber and switching that business customers are increasingly demanding. Moreover, business customers are price-elastic when it comes to telecommunications. As this Commission has concluded in the past, business customers "will switch carriers in order to obtain price savings and desired features,"[5] and large users

---

[4] Jack Grubman, "U.S. Telecom Services Industry Review," Salomon Brothers, April 11, 1997, p. 16.

[5] Report and Order, *In the matter of Competition in the Interstate Interexchange Marketplace*, FCC CC Docket No.

have stated that they routinely submit request for proposals (RFPs) before procuring telecommunications services.[6]

28. As shown in Table 1, the U S WEST territories provide ample evidence of current, active competition in every major business center and some tier 2 and tier 3 markets. Given the fact that roughly 30% of U S WEST's lines are business lines,[7] the competitive presence of CAPs in most major business centers is more than just emerging competition. It is indisputable competition. The success of CAPs in staking their business around serving high revenue business customers will directly exacerbate the inefficiencies of asymmetric regulation and destroy the viability of much of the current regulation of incumbent LECs.

90-132, Released: September 16, 1991 (Interexchange Competition Order), ¶ 37.

[6] Id., ¶ 38.

[7] Jack Grubman, supra n. 4, p. 22.

Table 1: CAP/CLEC Presence in the U S WEST Territories

Business Area	Competitors	# Route Fiber Miles
ARIZONA		
Phoenix	Cox	42
	City Signal	17
	ELI	209
	ICG	12
	MFS	146
	Phoenix Fiber	14
	TCG	14
Tucson	ACSI	109
	Brooks Fiber	64
	GST	32
COLORADO		
Denver Area (Includes Boulder and CO Springs)	ICG	339
	MFS	32
	TCG	160
IOWA		
Cedar Rapids	McLeodUSA	25
Council Bluffs	McLeodUSA	11
Davenport	McLeodUSA	1
Des Moines	McLeodUSA	130
Dubuque	McLeodUSA	3
MINNESOTA		
Twin City Areas (Minneapolis and St. Paul)	Fibercom	4
	MCI	3
	MFS	5
	Means	12
NEBRASKA		
Omaha	TCG	165
NEW MEXICO		
Albuquerque	ACSI	56
	Brooks Fiber	3
	GST	68

Table 1 Cont'd: CAP/CLEC Presence in the U S WEST Territories

Business Area	Competitors	# Route Fiber Miles
OREGON		
Portland	MCI	5
	MFS	5
	ELI	190
UTAH		
Salt Lake city	ELI	80
	Phoenix Fiber	65
	TCG	50
WASHINGTON		
Seattle	AT&T	.3
	ELI	100
	Fibercom	90
	GST	6
	MCI	54
	MFS	150
	Sprint	4
	Starcom	18
	Summit	.3
	TCG	314
	Telcom	.3
	Viacom	16

Source: U S WEST Fiber Deployment Summary (3/28/97) citing *Inside the Competitive Local Exchange* (1996); MIDS Database; U S WEST Competitive Intelligence Reports; and Local Market Industry Publications

29. The need for ILEC contracting currently derives from the presence of formidable competitors in the marketplace. Incumbent LECs simply must be allowed to compete for the significant

access customers that are targeted by their competitors. An inability to enter into contractual arrangements for interstate services that reflect the mutual interests of ILECs and their customers will benefit competitors and not competition, will harm customers by limiting their options and prices they can choose among and, in the end, results in all of society being the losers.

III. Any Competitive Concerns are Unfounded

30. Contracts by ILECs for access services, as discussed above, would be procompetitive and would lead to greater economic efficiency and societal well-being. There is no reason to believe that such contracts would cause competitive harm. In the first place, the contracts would be based on sound economic rationales and, therefore, would reflect competitive realities. Any firm that is at least equally efficient should be able to offer a competitive service with the same terms as those contained in the incumbent LEC's contract.

31. However, in addition to the discipline imposed by a potential alternative offering by a facilities based competitor, the service provided under the ILEC's contract could be resold by a competitor. Thus, resellers will have access to the same terms and conditions as those contained

in the contract. This protection assures that, not only can similarly situated customers gain access to the terms and conditions offered by the service under contract, but competitors could purchase the service under the contractual terms and conditions and offer it for resale.

32. One very important point is that there is no incentive for the dominant LEC to offer a service under contract that is priced below its cost. Several reasons assure that there is a lack of incentive for sales below cost. First, the only motive proffered for selling below cost is predation i.e., selling below cost to drive a competitor from the marketplace. In order for any such strategy to be successful, the firm engaging in predatory activities must be able to outlast its would-be victims and then it must be able to recoup the losses incurred from the below-cost sales by subsequently raising its price. The firms with whom the incumbent LECs are now competing are not small firms with empty pockets, nor would such actions go unnoticed. The likelihood that they can be driven out of the marketplace by sales below cost is virtually non-existent.

33. Even if such an event were hypothetically possible, competitors' facilities would still be in place and could be purchased by another competitor or would-be competitor. Thus the ability of the predator to raise price and recover

its losses would be held in check, negating the purpose for predation to begin with.

34. Most importantly, though, sales below cost just do not make sense when ILECs are required to resell services sold under contracts. A reseller can purchase the product on a below-cost basis at resale and then resell it.[8] This means that the dominant LEC would be subsidizing its competitors. We know from the arguments over reselling residential local service, which is usually priced below its costs, that LECs are not anxious to engage in that type of activity.

35. My conclusion is that the availability of resale allays any concerns that might otherwise arise from the use of contracts for access. It provides an added layer of protection from any possible competitive harms.

---

[8] LECs are required to offer for resale at wholesale rates any service that it provides at retail to noncarrier subscribers with "no exceptions for promotional or discounted offerings, including contract and other customer-specific offerings." First Report and Order, *In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, Interconnection Between Local Exchange Carriers and Commercial Radio Service Providers*, FCC CC Docket No. 96-98, 95-185, Released: August 8, 1996, ¶ 948.

IV. The AT&T Analogy

36. As I have discussed at some length above, there are myriad persuasive reasons for allowing dominant LECs to enter into contracts with their customers for their access services. Even if there was no previous history of the Commission allowing the practice, it should be allowed. However, as I show below, the issues raised in the question at hand (the ability of LECs to file customer specific access contracts) have all been hashed out before. In the period 1987 to present, AT&T has progressively won greater and greater freedom to respond to individual customer needs and competitive pressures. The record shows that the benefits have been great for the business customers who have been involved. To the extent that these customers now pay prices that are closer to costs and that costs and uncertainty have been reduced, society has benefited as well.

A. The FCC has previously addressed this type of circumstance

37. The Commission long ago provided AT&T, even as a dominant provider of interexchange services, the ability to respond to the needs of individual customers. Initially, AT&T was authorized to use its Tariff 12, which was filed in 1985 to provide services to the Defense Department. The

first commercial Tariff 12 VTNS (Virtual Telecommunications Network Service) option was for Du Pont in January 1988, and was followed by options for Ford, American Express and American Airlines later that year.[9] The principle underlying the Tariff 12 VTNS option was (and remains) to integrate various services and technologies and thereby provide a turnkey, individualized private network for large customers. However, "instead of reconfiguring lines and redesigning topologies, in many cases what the carrier [AT&T] has done is merely to sell the same network on a bulk purchase basis."[10]

38. The Commission immediately began investigating the legality of Tariff 12, and tentatively concluded that they were unlawful because of certain restrictions (e.g., geographic) contained in the tariffs. Significantly, however, the Commission found that integrated service packages tailored to individual customers were not "like" their component services as the term would be used to find them unjust or unreasonably discriminatory under the

---

[9] Candee Wilde, "Where's Tariff 12 Going?" *Communications Week*, October 29, 1990, p. 1.

[10] Paul Strauss, "Inside AT&T's Tariff 12 Deals," *Data Communications*, February, 1990, pp. 99-110.

Communications Act.[11] AT&T was directed to file revisions to its Tariff 12 to eliminate the unlawful restrictions on availability, and the Commission noted its expectation "that both AT&T and the nondominant carriers would continue to offer integrated service packages, given customer demand for them."[12] Tariff 12, then, became the first method by which AT&T priced and offered services in a customer-specific arrangement.

39. Tariff 15 became the second way in which AT&T began to more flexibly respond to customer demands and competitive pressures. Competitive Pricing Plans (CPPs) under Tariff 15 were designed to enable AT&T to offer regular services to a specific customer(s) "at rates established to respond to competition."[13] In the first CPP, AT&T offered Holiday Corporation discounts of 5 percent to 10 percent on its PRO America II services and justified its Tariff on the grounds that it was "a competitive response to an off-tariff

---

11 Memorandum Opinion and Order, *In the Matter of AT&T Communications, Tariff FCC No. 12*, FCC CC Docket 87-868, Released: April 18, 1989, ¶ 23.

12 Memorandum Opinion and Order on Reconsideration, *In the Matter of AT&T Communications, Tariff FCC No. 12*, FCC CC Docket 87-868, Released: November 8, 1989, ¶ 2.